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SUBJECT: Snapshot of German Economy - Growth Remains Modest

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11. (SBU) Summary: Germany remains on track for a mild economic revival this year, with 0.4% GDP growth in the first quarter of 2006 and expectations of 1.8% for the year as a whole. Recent unemployment figures were better than expected after the disappointing start earlier in the year. Business confidence indexes remain strong, and first-quarter growth, unlike in past quarters, saw a significant boost due to increased investment in capital goods, as opposed to just exports. However, the coalition's recently agreed health reform plans seem likely to raise payroll-based contributions to the state health system, thereby missing the key reform goal of bringing down non-wage labor costs. In late June, business leaders complained to the Chancellor and other ministers that the pace of reform was too slow. Business leaders have also noted that strong performance overseas does not mean leading German firms are doing well in markets at home. End Summary.

MIXED PICTURE

12. (U) After a stagnant final quarter of 2005, Germany's economy saw modest growth in the first quarter of 2006, with 0.4% growth (seasonally, calendar and price adjusted), slightly below the expected 0.5%. Strong export-sector performance helped stimulate increased confidence among consumers and those planning domestic plant investments. German manufactured goods exports rose 4.5% in the first quarter over the record numbers Germany saw last year. On the domestic side, capital goods investment was up 2.2% and accounted for a significant portion of the rise in GDP. Producers of capital and intermediary goods, especially the machine tool and chemical industries, enjoyed a backlog of orders as firms worldwide looked to expanding their production capacities. Private household consumption improved somewhat rising 0.6% in the first quarter after stagnating in 2005.

13. (U) The FIFA Soccer World Cup too seems to have had a positive effect on certain industries with increased sales in consumer electronics, merchandise, and travel. However, a real turnaround for the chronically weak German retail sector remained elusive, even with longer shopping hours - including on Sunday - for the duration of the tournament. In the face of continued high unemployment and stagnant wage growth, the World Cup did, however, create an estimated 50,000 to 60,000 temporary jobs. A more lasting effect may be a boost in tourism to Germany, a sector that already employs more than 2.8 million, due to the positive coverage generated by the event.

14. (U) Business confidence indicators are again positive,

recovering in June after the drop some saw in May. The IfO Index, based on a poll of 7000 companies, fell in May for the first time in twelve months as business people's outlook for the coming six months slightly clouded. Business analysts were therefore surprised when in June renewed optimism about the current situation and the business outlook pushed the index to a 15-year high. The ZEW Indicator of Economic Sentiment too fell 12.2 points for May, finishing only slightly above its historical average at 37.8 points. Analysts cite uncertainty about further interest rate hikes (after the European Central Bank announced a rate increase of 0.25 basis points to 2.75% June 8), high oil prices, and slower global growth as causes for concerns for German business leaders.

JOB FIGURES -- THE FOCUS FOR GERMAN POLITICIANS AND REPORTERS

15. (U) The number of unemployed in the total German workforce remained high at 4.7 million during the first quarter; the unemployment rate was 11.3 percent in January-February and 11.4 percent in March (all figures seasonally adjusted). The colder than usual winter delayed seasonal improvement until the second quarter, but then the figures were better than expected: in April 4.691 million unemployed (11.3 percent), in May 4.596 million (11.0 percent), and in June 4.542 million (10.9 percent).

16. (U) Surveys indicate most German firms plan to keep their workforce at current levels, although the wholesale sector plans a slight increase in hires. In addition, wages remained stagnant in the first quarter (year-on-year), after falling 0.6% during the four preceding quarters, according to Economic Ministry officials. They expect projected inflation of 1.3% to offset a net 1.4% rise in 2006.

17. (U) In spite of continued wage stagnation, big-ticket purchases in advance of the January 1 VAT increase will likely boost consumption figures. The Bundesbank expects these advance purchases

BERLIN 00001950 002 OF 002

to add 0.25% to GDP growth this year. Economic Ministry officials expect the effect of the VAT hike to shave off a solid 1% of next year's growth, which could thereby stifle the domestic recovery. Finance Minister Steinbrueck called the VAT hike the "least bad of the options available to the Federal government" to help cover pension costs and help get the deficit to GDP ratio below the three percent Maastricht ceiling for the first time in five years.

Impatience OVER THE PACE OF Reforms

18. (SBU) While Chancellor Merkel can take much of the credit for Germans' increased optimism, businesspeople have begun criticizing the lack of progress on economic reforms the CDU/CSU-SPD Grand Coalition promised when it took office in November. Business leaders in the Federation of German Industry (BDI), Germany's leading business association, reportedly told Merkel and other ministers June 21 that their patience with the lack of progress on reforms was exhausted. BDI recently said in a statement that "doubts about the problem-solving ability of this government are growing." German business leaders have also emphasized in the meetings with Embassy officials that, although they are doing well in world markets, the situation at home remains difficult.

19. (SBU) For example, on the health reform plans the coalition agreed upon in early July, the parties openly squabbled about how best to move financing for the system away from payroll-based contributions and thereby reduce non-wage labor costs. The SPD proposed large income tax increases to shore up the system's financing while avoiding benefit cuts. But when Merkel indicated she might accept these tax increases, some state-level CDU leaders rebelled. The end result is a watered-down reform the government will send to the legislature that actually increases non-wage labor costs and postpones dealing with the long-term future of the health care system.

TIMKEN JR.